

Internal Revenue Service
memorandum

CC:TL:Br3

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date: NOV 17 1988

to: District Counsel, Greensboro SE:GBO

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Application of § 6621(c)(3)(A)(v) to non-tax shelter cases

This is in response to your request for technical advice dated September 7, 1988.

ISSUE

Whether the additional interest provision of § 6621(c)(3)(A)(v) applies to fraudulent or sham transactions which are not, at the same time, tax shelter transactions.

FACTS

You do not suggest any specific facts, but you point out the distinction between a tax avoidance scheme, such as a shelter, and "a good old fashioned fraud case" in which intent to evade is present. You also suggest one such case could be one in which the taxpayer used a nominee to divert earned income.

ANALYSIS

Section 6621(c) provides that where interest is payable "with respect to any substantial underpayment attributable to tax motivated transactions", the rate of interest on an underpayment "shall be 120 percent of the underpayment rate established under this section." I.R.C. § 6621(c). Section 6621(c)(3) defines a tax motivated transaction to include: any valuation overstatement; any loss disallowed by the at-risk rules; any disallowed investment credit; any straddle; any use of an accounting method resulting in distortion of income; and "any sham or fraudulent transaction." § 6621(c)(3)(A)(v). See also Treas. Reg. § 301.6621-2T.

Prior to the passage of the Tax Reform Act of 1986, § 6621(c)(3)(A)(v) did not appear in the Code, although § 6621(c), then designated § 6621(d), had been added by the Deficit Reduction Act of 1984. The language of the Committee Report, and the examples cited therein of tax-motivated

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transactions, suggest that Congress specifically intended to penalize tax-shelter investors.

In DeMartino v. Commissioner, T.C. Memo. 1986-263 and Forseth v. Commissioner, T.C. Memo. 1985-279, the Tax Court held that the § 6621(c) increased interest provision did not apply to tax shelter transactions which were shams, but would have applied to those same transactions had they been real, albeit lacking in the necessary profit motive. As you correctly point out, § 6621(c)(3)(A)(v) was added to legislatively reverse these holdings, which were specifically cited in the Committee Report. While both the DeMartino and Forseth cases are non-traditional shelter cases, See Rose v. Commissioner, 88 T.C. 386, 412-413 (1987), the Committee Report does not specifically restrict the application of § 6621(c) to tax shelters alone. The Temporary Regulations, § 301.6621-2T, do not address the question of what is a sham or fraudulent transaction.

In Cherin v. Commissioner, 89 T.C. 986 (1987), the Tax Court defined the phrase "sham or fraudulent transaction" for purposes of § 6621(c)(3)(A)(v) to include: fake or fictitious transactions; transactions where the taxpayer lacked profit motive and which were without economic substance; and transactions which lack economic substance, regardless of whether the taxpayer participated in the transaction with the requisite profit motive.

We have located a number of cases in which additional interest under § 6621(c) has been assessed. Most involve traditional "generic tax shelter" activities, which were defined by the Tax Court as movie financing, master recording purchases, books, lithographic material, inventions, and mining ventures. See Rose, supra. However, three of the reported cases do not fall into these categories.

In Price v. Commissioner, 88 T.C. 860 (1987) the taxpayers, who were brothers, were partners in three partnerships which purported to be "dealers" in Government securities. All of the trades were predetermined, and generated interest deductions for the taxpayers. The Service argued that these trades were sham transactions, designed to generate losses to the partnerships through the purchase and sale of fictitious securities. The addition to tax for fraud and the additional interest provision were also asserted. The Court held that certain distinct transactions were "fictitious, i.e. shams." 88 T.C. at 883. The Court also held one of the taxpayer brothers liable for the fraud addition, on the grounds that he had devised the scheme. 88 T.C. at 887-8. And both taxpayers were held liable for the increased rate of interest "with respect to those transactions which we found to be shams." 88 T.C. at 889. See also Freytag v. Commissioner, 89 T.C. 849, 886-87(1987).

In Kerr v. Commissioner, T.C. Memo. 1987-470, 54 T.C.M. (CCH) 576 (1987), the taxpayers set up a family trust. They relied on the trust promoters and failed to file returns. They were held liable for their deficiencies, the additions to tax for negligence, the addition for failure to timely file, and the increased interest of § 6621(c). The Court characterized the family trust as "a 'sham or fraudulent transaction' within the meaning of section 6621(c)." 54 T.C.M. at 580. The Service considers family trusts to be a non-traditional shelter. See LGM TL-13, Preparation of I.R.C. § 7408 Injunctions Cases for Referral to the Department of Justice p. 2 (1-22-88).

Finally, in Chellappan v. Commissioner, T.C. Memo. 1988-208, 55 T.C.M. (CCH) 827, the taxpayers invested in an equipment purchase program which involved what purported to be a revolutionary new photocopier. In fact the machines did not exist and were not placed in service. The entire program was a fraud perpetrated by the promoters upon the taxpayers. The taxpayers invested on the advice of their accountants, and believed the transaction was genuine. On the grounds that the machines did not exist, the Court disallowed the taxpayer's deductions for depreciation, interest, maintenance and management fees, as well as claimed investment tax credit. The Court imposed additional interest under § 6621(c) on the grounds "that these transactions were factual shams." 55 T.C.M. at 836.

The Tax Court is willing to impose the 120% additional interest rate where it has found a "sham transaction" within the meaning of Cherin, supra, i.e., a factually fake or fictitious transaction, or an economically fake or fictitious transaction, whether or not the taxpayer lacks a profit motive. Indeed, the Tax Court has applied § 6621(c) where the Court found that the debt was not bona fide, even though the taxpayers had a profit motive. Bailey v. Commissioner, 90 T.C. 558, 628-630. Because of the Tax Court's interpretation of § 6621(c)(3)(A)(v), we are not willing to categorically state that the § 6621(c) interest rate only applies to a tax shelter situation. See, e.g., Bailey, supra.

You argue correctly that Congress referred to tax shelters and tax shelter cases in adding § 6621(c) in general, and § 6621(c)(3)(A)(v) in particular, to the Code. Nevertheless, the Tax Court's broad interpretation of this language suggests that § 6621(c) can apply in cases that are not shelters.

Taxpayers could argue that the appearance of this phrase at the end of a list of common shelter devices suggests an intent that the sham transaction must be part of a shelter. However, the tax treatments enumerated in the list set forth in § 6621(c)(3) are susceptible to abuse in situations other than

tax shelters, and we do not believe a restriction of the use of § 6621(c) to tax shelters is warranted on that basis. See Bailey, supra.

To summarize, we believe that there are situations in which § 6621(c)(3)(A)(v) applies which are not traditional shelter cases. We think that if a case is a "sham or fraudulent transaction" within the meaning of Cherin, supra, § 6621(c)(3)(A)(v) may properly be asserted and upheld by the courts. However, to the extent that you concluded that this does not mean that any traditional fraud case is an appropriate vehicle for the assertion of the 120% interest rate, you were correct. Only cases in which the definition of "sham or fraudulent transaction" provided by Cherin, supra, is arguably satisfied are suitable for the assertion of the § 6621(c)(3)(A)(v) interest rate.

In your request for technical advice, you suggested the example of a taxpayer's use of a nominee to divert earned income. You seem to regard this example as "a good old fashioned fraud case." However, the term "tax shelter" is susceptible of broad definition, see Rose, supra, and § 6661(b)(2)(C)(ii). The sole focus in the § 6621(c) case should be on the Cherin, supra, analysis. Indeed, the example of a nominee can fit the Cherin analysis as a fake or fictitious transaction, or as lacking in economic substance and therefore a sham, or can be analyzed as a traditional fraud case. We believe that trying to establish clear distinctions between "fraud" cases and "shelter" cases is inappropriate in the context of § 6621(c). Much uncertain territory lies between the two camps. Accordingly, the focus must be on performing the Cherin, supra, analysis. If you wish further guidance, we will be glad to respond to a supplemental request for technical advice.

CONCLUSION

The increased rate of interest provided for by § 6621(c)(3)(A)(v) may properly be asserted in non-tax shelter cases of sham or fraudulent transactions. We will be happy to further advise you if you so desire.

Sincerely,

MARLENE GROSS

By: 

DANIEL J. WILES
Chief, Branch No. 3
Tax Litigation Division

Attachment:

Copy of request for technical advice

cc: Chief, Tax Shelter Branch

Internal Revenue Service
memorandum

CC:GBO-TL
AIWeinberg


date: SEP 7 1988

to: Director, Tax Litigation Division
Attn: Chief, Tax Shelter Branch

from: District Counsel - Greensboro

subject: I.R.C. § 6621(c)(3)(A)(v)

This office has taken the position that I.R.C. § 6621(c)(3)(A)(v) was intended only to apply to tax shelter type transactions; and a sham or fraudulent type transaction entered into to defraud the Government (a good old fashioned fraud case) is not the type of sham or fraudulent transaction intended by the addition of section 1535 of the Tax Reform Act of 1986. It seems clear that section 1535 was specifically enacted to overrule two Tax Court decisions involving tax shelter profit motive cases. Also, I.R.C. § 6621(d) was enacted by the Deficit Reductions Act of 1984, section 144, (increased rate of interest on substantial underpayments attributable to certain tax motivated transactions) for the purpose of charging additional interest in tax shelter cases. However, your views on this position will be appreciated since our Examination Division believes in appropriate fraud cases, i.e., taxpayer used a nominee to divert income earned, (sham), that section 6621(c) interest can be charged.


ALAN I. WEINBERG
District Counsel

AIW/ds